Public Benefit and Accountability in the Exempt Sector

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Frances R. Hill
Professor of Law and Director, Graduate Program in Taxation
University of Miami School of Law
Coral Gables, Florida

Thank you for the opportunity to participate in this Roundtable. The comments presented here represent my personal views and not the views, if any, of the University of Miami.

I endorse the focus on transparency and accountability in the Bipartisan Staff Discussion Paper. I believe, however, that both the focus on transparency and accountability and the specific proposals would have greater analytical force and persuasive effect if they were grounded in a more fully specified analytical framework permitting a more comprehensive examination of exemption and exempt entities.

This paper suggests that exemption is necessarily grounded in the provision of a public benefit and that the provision of a public benefit cannot be determined by the absence of a private benefit. The paper recommends that the benefits of exemption be targeted more efficiently to the activities that sustain exemption by providing a public benefit. Efficiency of this type is possible only if more attention is paid to the operation of exempt entities. Current law sustains inefficient diversions of the resources of exempt entities from exempt activities to activities that are unrelated to exemption and in some cases inconsistent with exemption. After an initial discussion of what I am calling a "nondiversion constraint," the paper will offer comments on certain of the specific proposals in the Bipartisan Staff Discussion Paper. The following two section of the paper discuss political activities of exempt entities and the misuse of exempt entities as financing conduits for terrorist activities.

I. Operating for a Public Benefit: Crafting a Nondiversion Constraint

Exemption, and the charitable contribution deduction for contributions to section 501(c)(3) organizations, are subsidies granted by Congress to support the public benefits provided through exempt entities. The various types of exempt entities provide different types of public benefits to differently defined classes of beneficiaries. Section 501(c)(3) organizations, whether public charities or private foundations, provide benefits to a charitable class of beneficiaries who have no other relationship to the organization, while section 501(c)(4) social welfare organizations provide a public benefit to persons who support the organization. Public charities and private foundations are structures for reallocating resources, while social welfare

organizations are structures for addressing the free-rider problem inherent in collective action for shared benefit. Section 501(c)(5) labor organizations and section 501(c)(6) business leagues provide benefits for members, as do the social and fraternal organizations.[1] The point of this summary is to underscore the centrality and breadth of the concept of a public benefit across the diverse types of exempt entities.

The public benefit touchstone for exemption has gradually become less important in policy discussions and academic analyses. Indeed, it has been largely replaced by a framework based on interdicting private benefit. The dominant academic paradigm of nonprofit law is based on the private benefit avoidance framework presented by Professor Henry Hansmann, whose work explained the "nondistribution constraint."[2] Much of the last twenty years has been devoted to crafting and then attempting to implement what ultimately became section 4958, the regime of monetary sanctions on excess private benefit. This is, of course, a matter of central importance. The continuing scandals referenced in the Bipartisan Staff Discussion Paper provide evidence that this issue remains central and that continuing vigilance in compliance efforts by the Internal Revenue Service (the "Service") remains vital.

It is also true that solving the private benefit problem would not in itself guarantee that exempt organizations operated for the public benefit that sustains their claim to exemption. The absence of a private benefit is not the same as the presence of a public benefit. Current law permits exempt entities to use their funds, including funds that have benefitted from the charitable contribution deduction, to be used for a broad range of activities that do not sustain exempt status, including commercial activities and electoral campaign activities that have, at best, a tenuous and indirect relationship with the provision of a public benefit. These activities are permissible activities provided that they do not become an organization's primary activities. Exempt organizations are clusters of activities, only some of which are linked to the provision of the kind of public benefit that sustains exemption.

These various activities, both exempt activities and merely permissible activities, are funded with diverse sources of revenue. Exempt entities derive funding from government grants and contracts, contributions, dues, and earnings from commercial activities, many of which are not subject to the unrelated business income tax. This white paper will not focus on the details of the unrelated business income tax or on the mixed consequences of exempt organization's dependence on government funding, which was a source of concern to the Filer Commission

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[1] For detailed discussions of each of these types of exempt entities, *see* FRANCES R. HILL & DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS (Warren, Gorham & Lamont 2002, with supplements twice each year).

[2] Hansmann, The Role of Nonprofit Enterprises, 89 Yale L. J. 835 (1980); Reforming Nonprofit Corporation Law, 129 U. Pa. L. Rev. 497 (1981).

almost thirty years ago.[3] Instead, the focus here is on the use of various sources of revenue to fund the multiple exempt and permissible activities of exempt organizations. This paper suggests that the diversion of resources requires the development of what I have called a "nondiversion constraint."[4]

The nondiversion constraint proposed here is consistent not only with efficiency but also with enhanced accountability. It focuses audit and guidance resources on the actual operations of exempt entities and would support collection of information on a revamped Form 990 and Form 990-T, or their successors, that would permit the Service, an organization's members, and the interested public to monitor the activities of exempt entities. This participatory approach to accountability depends on transparency with respect to the actual operations of the organizations in question. The regulatory approach taken in the Bipartisan Staff Discussion Paper is also dependent on access to this kind of information. A combined regulatory and participatory approach is likely to result in a more robust and accountable exempt sector than would either by itself. Participatory monitoring by members with the right to vote on the election of directors and officers, as well as on important issues, would also assist in implementing the nondistribution constraint. It would be easier and faster to vote offending insiders out of their positions than to rely solely on administrative and judicial remedies.

II. Comments on Specific Proposals in the Staff Discussion Paper

A. Five-Year Review

I agree with the Bipartisan Staff Discussion Paper that continued monitoring of exempt entities is essential and is largely absent in the current system. However, the proposal for a five-year review seems to me a misapplication of scarce administrative resources. I fear that this requirement would become more a matter of form than of substance. Whether the Service needs more resources or whether it could do more with the resources it has remains to be determined by others.

As the paper sets forth in the previous section, crafting a nondiversion constraint based on information about the actual operation of exempt entities and enforced through a regime of transfer taxes would make a five-year review unnecessary. Adequate information from exempt

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[3]Commission on Private Philanthropy and Public Needs, Giving in America: Toward a Stronger Voluntary Sector (1975)(the Filer Commission). The report notes that government funding is growing and is essential but expresses the concern that "[t]he more a private nonprofit organization depends on government money for survival, the less 'private' it is going to be, the less immune to the influence of public political processes and priorities." Id. at 96. The Commission concluded that "the presence of a firm core of private support, however small, in a private organization that gets major public funding can be of crucial importance in determining whether the managers of the organization regard themselves and behave as independent operators or as civil servants." Id. at 99.

[4]Hill, Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint, 56 Sn. Meth. Univ. L. Rev. 675 (2003).

entities would permit enhanced administrative efficiency.

B. Donor Advised Funds

Donor advised funds are new entities and, as such, they should be subject to careful review. But, enacting particular remedies should be reserved until the nature and dimensions of particular problems are more fully understood. While any conclusions about donor advised funds are premature, it might be useful to think of three categories of donor advised funds based on the nature of the fund sponsor or promoter. The three types of sponsors or promoters are taxable investment companies, other exempt organizations, and individual entrepreneurs. All donor advised funds present certain common issues relating to questions about continued donor control, *quid pro quo* benefits to donors, and the timing of completed gifts and thus the proper taxable year for a claim to a charitable contribution deduction under section 170.

At the same time, each of the three types of donor advised funds would appear to present a distinctive issue related to the nature of its sponsor/promoter. The funds operated by investment companies may pose the risk of being used to support the sponsor's taxable mutual funds by having the resources of the donor advised fund invested to shore up the market price of particular stocks. Whether this in fact happens and whether the result is an impermissible private benefit to the sponsor and the taxable investors in its other funds, or whether this practice, if it occurs, simply reflects market synergy remains to be determined, perhaps through collaboration with state officials or with regulators of securities markets. Donor advised funds operated by other exempt organizations raise questions relating to the professional competence of the investment advisers making the investment decisions. They also pose questions relating to possible pressure to direct earnings to either the sponsor or to organizations related to the sponsor. Donor advised funds operated by individual entrepreneurs seem the most likely to present the risk of scams to defraud the donors to the direct benefit of the sponsors/promoters. If this risk is in fact occurring, greater information is need to protect the public. Many of these schemes might well be matters for law enforcement and might not require changes in the provisions providing for exemption for properly run donor advised funds.

Perhaps none of these issues will prove to be material. Perhaps there are other issues. At this point too little is known to say and too little is known to support particular legislative proposals.

C. Exempt Entities and Tax Shelters

The proposal to revoke the exempt status of organizations serving as accommodation parties in tax shelter transactions addresses an important issue that impacts the broader effort to combat tax shelters and maintain the integrity of the federal income tax system. I applaud Commissioner Everson's leadership in the tax shelter area.

The Service recently announced an important initiative to treat an exempt accommodation

party as a participant subject to the registration, disclosure, and list maintenance requirements of the tax shelter regulations.[5]

In addition, the Service has announced a well-conceived proactive plan to review existing listed transactions with a view to assess the role of exempt organizations as accommodation parties or even promoters.[6] These efforts should receive the support necessary to make them effective.

Revocation of exemption might have less impact than one might anticipate. The Service has proved quite reluctant to enforce sanctions that require revocation of exempt status as the sole option. The history of the inurement prohibition and the development of the section 4958 excess benefit transaction monetary sanctions as an alternative is worth considering in this context. While audits are confidential, it would not appear that the Service has revoked exempt status for electoral campaign intervention short of clear cases of express endorsements of candidates, in part, one could reasonably suggest, because revocation seems unduly harsh. It is far from clear what use the Service has made of section 4955 as an alternative to revocation in this area. There is little reason to think that revocation of exempt status in tax shelter cases would not encounter a similar reluctance, especially where the amount derived by the organization from the shelter activity is insubstantial and the definition of a tax shelter is open to interpretation.

An alternative to revocation would be to tax earnings from serving as an accommodation party as unrelated business income earned from providing a service. The service is serving as an accommodation party in a tax shelter. Revocation would be appropriate in cases where the exempt entity has served as an accommodation party in multiple shelters or where the exempt entity is operating as a specially-created special purpose entity primarily for this purpose. In these cases, use of the fee income for exempt activities should not be a mitigating factor.

D. Insider and Disqualified Person Reforms

Scandals based on personal greed do not in themselves support additional legislation. As the first section of this paper suggests, existing provisions, perhaps with some modifications, permit the Service and law enforcement authorities to address these issues.

E. Grants and Expense Reforms

I support the general purpose of these proposals and see them as consistent with an exemption regime based on both a nondistribution constraint and a nondiversion constraint.

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[5]Notice 2004-30, 2004-17 I.R.B. 1.

[6]See the comments made by Sarah Hall Ingram and Thomas Terry at the May 2004 meeting of the Exempt Organizations Committee of the Tax Section of the American Bar Association. A transcript of these comments is available in The Exempt Organization Tax Review of July 2004 at pages 38-43.

The major shortcoming of these proposals is to limit them to private foundations. Public charities and other exempt organizations also make grants, or at least move money to other exempt entities. There is an urgent need for the Service to develop mechanisms enabling it to "follow the money." This has become quite clear in the case of political campaign activities and terrorist financing, which are discussed below. However, the most compelling case for following the money rests not on these special situations but on the need to know more about the routine operation of ordinary organizations.

The only available guidance on tracing money from public charities was issued thirty-six years ago,[7] and there has been virtually no subsequent discussion of its practical application. What records should an organization keep? What sanctions apply if the organization does not monitor the use of its funds and maintain adequate records documenting its monitoring regime? No one knows, but the Service and the public need to know. The nondiversion constraint set forth in the first section of this paper would be consistent with such a tracing system.

F. Encouraging Strong Governance and Best Practices for Exempt Organizations

While many of these proposals are thoughtful approaches to achieving greater accountability, the missing element is the role of members with voting rights. Exempt organizations should be transparent, accountable, and participatory. Members should have the right to vote for board members and for officers. In addition, certain actions by the board should require member approval and members should have procedures through which they can direct the organization to use its resources in particular ways. Such proposals would introduce a marked change in the governance and the operation of public charities and social welfare organizations, but they would bring less marked changes to labor organizations, business leagues, and social and fraternal organizations.

III. Exempt Entities and Political Campaigns

In *McConnell v. FEC,*[8] the Supreme Court upheld all the major provisions of the Bipartisan Campaign Reform Act of 2002 ("BCRA"),[9] and located exempt entities at the heart of the political money transactions it condemned. In so doing, the Court painted a portrait of exempt organizations as owing more to Tammany Hall than to Tocqueville, more to machine politics than to civil society.[10] The Court repeatedly described exempt organizations as soft

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[7]Rev. Rul. 68-489, 1968-2 C.B. 210.

[8]*McConnell v. FEC*, 124 S. Ct. 619 (2003).

[9]Bipartisan Campaign Reform Act of 2002 ("BCRA"), P.L. 107-155, 115 Stat. 81, which amends the Federal Election Campaign Act of 1971 ("FECA"), 86 Stat. 11, as amended, 2 U.S.C. section 431 et seq.

[10]For a discussion of this case, *see* Hill, *McConnell* and the Code: Exempt Organizations and Campaign Finance, 45 The Exempt Organization Tax Review 71 (July 2004).

money surrogates that facilitate the circumvention of federal election to the detriment of democratic process, including, importantly, voters' rights to information on which to base their voting decisions. The Court even predicted that efforts to use exempt entities to circumvent election law might intensify as pre-BCRA soft money expedients are necessarily abandoned. In fact, this seems to be what is happening in the 2004 election cycle. We are seeing a dramatic increase in hard money contributions to both major political parties and intense efforts by operatives linked to both parties to design new soft money surrogates.[11]

In light of this important decision, exempt organization managers and their professional advisers urgently need guidance on the implications of BCRA for exempt entities as well as on other topics pre-dating BCRA. Long-unaddressed topics center on the core issue of distinguishing participation or intervention in political campaigns from legislative lobbying and from education of the public on issues, including controversial and contentious issues. The most recent revenue ruling in this area dates from 1986.[12] In the intervening years campaign tactics have changed and exempt organizations' roles have changed.

The continuing absence of precedential guidance has created a moral hazard which facilitates noncompliance by those seeking to use exempt organizations as soft money surrogates and puts those organizations that wish to comply at relative disadvantage by causing them to be more cautious than would otherwise be permissible in a properly administered tax system. Of course, certain of these complexities could be avoided if the Federal Election Commission ("FEC") would properly administer FECA and treat those organizations functioning as soft money surrogates as political committees subject to the requirements of FECA.[13] Yet, even if the FEC reversed its present course, tax issues would remain.

Decisions by the Service in particular cases in recent years have only intensified the confusion in this area. The positions taken in the private ruling issued to the Progress and Freedom Foundation,[14] which served as a financing vehicle for then-Congressman Newt

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[11]For a discussion of types of political money raised or transferred or deployed through exempt entities, *see* Hill, Softer Money: Exempt Organizations and Campaign Finance, 91Tax Notes 477(April 16, 2001). *See also*, written testimony prepared by Frances R. Hill for the 2004 hearings held by the FEC on a rulemaking proposal to treat certain exempt entities as political committees under FECA. This testimony is available on the FEC website, www.fec.gov.

[12]Rev. Rul. 86-95, 1986-2 C.B. 73 (candidate forums); Rev. Proc. 86-43, 1986-2 C.B. 729 (an effort to suggest when advocacy constitutes education).

[13]These issues were considered most recently by the Senate Rules Committee in hearings held on July 14, 2004.

[14]This ruling was never released publicly by the Service, but the helpful people at the Progress and Freedom Foundation posted it on their website and its was then made available online by Tax Analysts at 1999 TNT 24-25. The positions taken in this ruling were apparently developed by senior officials in the National Office when it appeared that the appropriate District Office intended to take the position that the Progress and Freedom Foundation did not qualify for exempt status as an organization described in section 501(c)(3). *See* a memorandum prepared by

Gingrich's self-described effort to recruit Republican Party candidates and activists, seems inconsistent in both its result and its reasoning with much of the guidance previously issued by the Service as well as with the fact record compiled by the House Ethics Committee during its investigation of this matter.[15] The recent determination restoring the exempt status of the Abraham Lincoln Opportunity Fund remains unexplained and, at least to this observer looking at the facts from the outside, inexplicable.[16] These cases loom much larger than they might otherwise in view of the dearth of meaningful guidance. It is all too easy to treat these cases as a signal that anything goes, or does if one is powerful or has powerful connections. This is the kind of cynicism that the Supreme Court found so corrosive of trust in government and thus of our democratic system in its opinion in *McConnell*. I am not suggesting that the Service reveal facts about particular cases that it cannot properly reveal under current law. I am suggesting that it could have issued, and should still, issue guidance that would address these concerns.

When the Service does issue a revenue ruling in this area, as it did in 2004, it should avoid intensifying the confusion and exacerbating the moral hazard. Revenue Ruling 2004-6 does not fully satisfy this standard.[17] While it is helpful in illustrating the application of section 527(f)(1) when section 501(c)(4) social welfare organizations, section 501(c)(5) labor organizations, and section 501(c)(6) business leagues engage in activities that fall within the section 527(e)(2) definition of an exempt function, the ruling introduces a new term, "political advocacy communication," that it fails to define or to apply. There is no statutory basis for this term and no reason that it should have been introduced. To what does it refer, even in the context of Revenue Ruling 2004-6? To all of the communications described in the six examples in the ruling? To a subset of them? To none of them? One simply cannot tell, but it should not be too difficult for advocates to use this phrase to make new claims to the right of exempt entities to circumvent election law.

In this area, administrative guidance is a more pressing need than is additional legislation. Indeed, I do not see any need for tax legislation in this area. I do, however, see a need for prompt precedential guidance from the Service. The Service should be applauded for its recent letter to

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Associate Chief Counsel Sarah Hall Ingram disagreeing with the proposed adverse determination at 2000 TNT 51-17.

[15]Hill & Mancino, *supra* note 1, considers this issue in some detail in Chapter 6. For the most fully developed factual record in this matter, *see* Report of the Select Committee on Ethics, In the Matter of Representative Newt Gingrich, House of Representatives, Report 105-1, 105th Cong., 1st Sess. (1997).

[16]For a discussion of the background of this issue, *see* Tax Exempt Status Restored to Groups with Gingrich Ties, 2003 TNT 72-4.

[17]Rev. Rul. 2004-6, 2004-4 I.R.B. 1.

seven national political parties advising them not to use exempt entities in their efforts.[18] This letter does not, of course, address the gap between current campaign practices and the available guidance, all of which was issued before the soft money explosion of the 1990s. Two of these broad issues arise from or are given particular force by BCRA. Other issues pre-date BCRA.

The first issue arising from BCRA is the effect on exempt status of making expenditures for an electioneering communication as defined in Title II of BCRA. Is this activity simply ignored for tax purposes? Is it treated as prohibited participation or intervention? The examples in Revenue Ruling 2004-6 have been carefully crafted to avoid this issue. This issue is likely to arise with some force during the 2004 election cycle, especially with respect to section 501(c)(3) public charities. This surprising situation arises from the FEC regulation taking the position that the electioneering communication provisions do not apply to public charities.[19] There is no statutory basis for this position, but it presents obvious planning opportunities for the circumvention of election law that so concerned the Court in *McConnell.*

The second issue arising from BCRA is the effect on exempt status of having various types of soft money pass through exempt entities. This is heart of the Court's concern about circumvention of election law in *McConnell.* What is the impact on exemption? Do these effects arise from the eventual use of the money? Does the source of the money matter? Is serving as a conduit enough to trigger adverse consequences for exempt status? Questions of tracing political money into and out of exempt entities are not new, but the Court has now defined the Constitutional reasons for dealing with them.

In addition to these issues arising from BCRA or given new force by BCRA, there is a significant inventory of largely unaddressed issues of fundamental importance that together constitute the moral hazard of current law. While it might appear that identifying a list of specific practices would be the most helpful approach, it is regrettably true that the continuing failure to address fundamental principles makes this approach counterproductive. Two fundamental issues require clarification in their application to campaign activity. One is the distinction among education, lobbying, and political campaign intervention. In practice, these categories intersect and overlap.[20] How are these overlapping situations to be treated? What factors are likely to be considered in deciding? A second is whether campaign participation will be treated as a private benefit subject to general private benefit limitations or to section 4958 sanctions. It should be noted that section 4958 applies to section 501(c)(4) organizations, which are becoming increasingly important soft money surrogates, as well as to section 501(c)(3) public charities.

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[18]Letter of June 10, 2004, from Tax Exempt/Government Entities Commissioner Steven T. Miller is available at 2004 TNT 113-23.

[19]11 C.F. R. § 100.29(c)(16).

[20]For a preliminary effort to map these intersections and identify the issues they raise, *s*ee Hill, Softer Money, *supra* note 11.

Considering the political campaign roles played by exempt entities underscores the importance of understanding exempt organizations as aggregates of activities and developing an approach to exemption based on identifying and taxing diversions of resources within the organization.

IV. Exempt Entities and Terrorism

The misuse of exempt entities to finance terrorist activities poses unusual difficulties. The policy choices made in this area impact not only the vital work of exempt organizations here and abroad, but also our civil liberties and our national security. I have chosen to address these issues here because I wish to caution against simple analyses and easy solutions. The most serious error we can make in this area is to overestimate what is currently known. Very little is reliably known, including the dimensions of the problem. Yet, terrorist financing can never be treated as a small issue even if we could establish that exempt entities play only a small role in it.

There is enough evidence to conclude that some exempt entities around the world are playing some roles in diverting to terrorist uses money ostensibly collected for charitable purposes. Some United States entities appear to be raising money for the purpose of diverting it. Some of this money is raised from innocent contributors, but some contributors are fully aware of the intended diversion. Some United States entities are receiving contributions from individuals or governments abroad for the purpose of supporting their terrorist activities in the United States. Some organization managers are directing the diversion of funds, while some may be unaware of diversions occurring once the funds have left their organizations. We have yet to develop a fully satisfactory conceptual map of the patterns of diversion within even United States entities.

It is not likely to be useful to think of most organizations as "terrorist organizations." Even some of the organizations abroad that engage in terrorism as a matter of policy also engage in undeniable charitable activities, in some cases filling a void left by failed states or failed governmental authorities. Does supporting the charitable activities of these organizations also mean support for terrorism? United States law say yes, but most of Europe takes the opposite position.

The Supreme Court's recent decisions dealing with the rights of detainees provide useful guidance in this area.[21] These opinions are useful precisely because they are tentative. They recognize that balancing civil liberties and national security calls for careful consideration of actual situations. At the same time, the Court's insistence on the preservation of access to certain rights to representation and to procedures for having one's case heard is introducing changes even at the Guantanamo detention camp. We have much to learn from these cases.

In this context, any effort to impose particular requirements on United States entities

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[21] *Hamdi v. Rumsfield,* slip opinion (June 28, 2004); *Rasul v. Bush*, slip opinion (June 28, 2004); *Rumsfield v. Padilla*, slip opinion (June 28, 2004).

operating abroad is at best premature. In some cases the government is asking, albeit informally, for information from exempt entities that the government itself has been unable to collect using the full resources of the intelligence services.

At the same time, exempt entities must come to understand that this issue is not purely or even primarily a tax issue and that organization's rights are no more absolute than are the rights of any other person. The issue is the delicate and difficult balance of civil liberties, including the right of association under the First Amendment, and national security. Efforts to assert associational rights are hampered by the absence of a Constitutional jurisprudence of association that meaningfully addresses the First Amendment right of association.

This is an area where the approaches that have been recommended in this paper with respect to the ordinary operations of exempt entities–the crafting of a nondiversion constraint and increased roles for monitoring by members–may have little effect. Criminal laws dealing with money laundering and other crimes, based on tracing money around the globe, may be the best way to deal with these issues. Criminal law, with its procedural protections, may strike the most appropriate balance in most cases. Extraordinary measures based on a national security rational should be measures of last resort.

I urge Congress to continue its active oversight role in this area and to involve the exempt sector in its efforts.

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